AN OVERVIEW OF
THE GOVERNOR'S 1999-2000 BUDGET PROPOSAL

On Friday, January 8th, Governor Davis unveiled his spending plan for the 1999-2000 fiscal year -- his first state budget.

The budget is now before the Legislature to review, analyze, debate, revise, and return to the Governor. Assembly Bill 135 (Ducheny) and Senate Bill 160 (Peace) will serve as the budget bills for the Assembly and the Senate, respectively. Multiple "Trailer Bills" will also be introduced in both houses as vehicles for policy changes necessary to implement the final budget agreement.

The Governor's 1999-00 budget proposal reflects a moderate growth in the California economy and a corresponding improvement in the state's fiscal condition. However, this growth is not as high as projected. When the Legislature adjourned the 1997-98 Legislative Session and the final 1998 Budget Act was signed, there was a projected reserve of $1.2 billion. Since then, revenue estimates have been revised downward and caseload driven costs have increased beyond the forecast, resulting in a $2.3 billion shortfall in the budget year. The actual revenues collected invariably change from revenue projections. Similarly, expenditures for caseload driven budgets are generally statistically close enough to be called accurate, but can be off by hundreds of millions of dollars.

For the most part, the Governor's proposed expenditure plan funds a "workload" budget", meeting statutorily required obligations with few significant policy initiatives. Although resources are scarce, the Administration still manages to put forth major initiatives in education—Governor Davis' highest priority.

Steady Economic Growth: The 1999-00 Governor's Budget assumes California's economy continues its modest rebound, still outpacing the nation.

California's economy is closely tied to the rest of the United States and the rest of the world. California sells approximately 35 percent of its gross output outside its borders—15 percent to foreign countries and nearly 20 percent to the other 49 states. By contrast, the United States as a whole trades little more than 10 percent of its Gross Domestic Product with other countries. However, half of California's foreign sales are to Asia, and sales to Asia have significantly declined during the last year. The balance is evenly divided between Mexico, Canada and Western Europe.

Jobs are being created at a steady pace while unemployment continues to drop. The national unemployment rate hit a 28-year low of 4.5 percent, while California's unemployment rate, which is showing moderate signs of improvement, hovered at 5.8 percent for most of the year. Nevertheless, the budget assumes less than 300,000 jobs will be created this year, compared to over 400,000 jobs last year.

Manufacturing and business services industries, including computer and related industries, continue to grow and add significant numbers of jobs to the state's economy. Nonfarm employment, which grew more than 3 percent in 1998, is estimated to advance 2.1 percent this year and approximately 2.4 percent in 2000.

California's housing and construction upswing is projected to increase given that the state is in a relatively early phase in the construction cycle, while construction nationwide is flat or declining. Additionally, low interest rates, the reversal of domestic migration and strong job growth will only help California construction.

As previously noted, most of the policy initiatives in the 1999-00 budget are in K-12 education. Specifically, the Administration proposes $444 million, the majority from Proposition 98, for a package of initiatives entitled "Raising Expectation, Achievement, and Development (READ) in Schools". This initiative is primarily aimed at improving reading skills, improving teacher quality, and increasing school accountability. Additionally, this budget provides resources to fund increases in: (1) various health programs; (2) housing proposals; (3) natural resource programs; (4) public safety programs; (5) trade and commerce programs; and, (6) employee compensation.

REVENUES

The State Relies Heavily on Income Taxes and the Sales Tax: The Department of Finance forecasts General Fund revenues of $60.3 billion for the year beginning July 1, 1999. This is 7.1 percent increase in revenues over the current year.

Table 1 displays the composition of the General Fund. Of the $60 billion in forecasted General Fund revenues, the Personal Income Tax (PIT) will generate about half the total revenue, or $30 billion. The Department of Finance expects PIT revenues to grow by almost six percent in the budget year. The state sales tax generates one-third of General Fund revenues, and is expected to grow by 5.7 percent. The Bank and Corporation tax, expected to grow by over six percent, constitutes about ten percent of the General Fund.

Table 1

GENERAL FUND REVENUE AS FORECAST BY THE DEPARTMENT OF FINANCE BY SOURCE 1998-99 AND 1999-00 (Dollars in billions)			
	1998-99	**1999-00**	**Percent Change**
Personal Income Tax (PIT)	$28.5	$30.2	5.8
Sales and Use Tax	18.6	19.7	5.7
Bank and Corporation Tax	5.9	6.3	6.2
All Other	3.2	4.1	28.0
Totals	**$56.3**	**$60.3**	**7.1**

As indicated in Table 1, other revenue sources will grow from a collective $3.2 billion to $4.1 billion (a 28 percent increase). Most of this extraordinary growth is attributable to unique events, including the national settlement with tobacco companies. The Department of Finance estimates that the tobacco settlement will generate $560 million for the General Fund each year for the next 20 years, starting in 1999-00.
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The Volatility of the Economic Forecast: In November of each year, the Department of Finance attempts to forecast the revenues for the year ending 19 months later. The forecast, however, cannot be made precisely. Small differences in the forecast can generate large budget changes, however. For example, if the forecast is too high by one percent, the error generates a $600 million deficit.

The possibility of forecast error is heightened by the state's tax structure: a progressive tax structure, such as California's, relies more heavily on high-income taxpayers. Small changes in the tax situation of the state's high-income taxpayers can have a large impact on PIT revenues.

Moreover, high-income taxpayers have a greater share of their income associated with capital gains, such as appreciation of stock portfolios. Capital gains are taxable only when the gain is "realized" by the taxpayer; that is, whenever the stock share is sold for a profit. As long as the taxpayer holds a stock, an appreciated stock's gain is unrealized and untaxed. High-income taxpayers have discretion over when they sell their stocks and realize their gains. They, therefore, can time their gains to be offset by other tax liabilities. Revenue forecasters have a difficult time forecasting when a taxpayer will choose to realize their capital gains.

As a result of these and related factors, it is difficult to precisely forecast state revenues on a timely basis. The Legislative Analyst has forecast, based on more recent revenue data, that revenues could be underestimated by approximately $400 million. When the Governor issues his May Revision, the Department of Finance will revise its revenue forecast, based on revenues realized in the first quarter of 1999. The Legislature will want to consider which forecast to use when crafting its version of the budget.

Policy Issues

Reserve: The Governor's Budget proposes a reserve of $415 million, slightly less than one percent. This is approximately $100 million more than was proposed in the 1998-99 January budget, but less than the Governor and many in the Legislature would like to see. As new forecasts become available, the Legislature will want to consider whether this amount can be prudently increased without harming necessary programs.

Trigger: The annual Budget Acts provides the Governor with the authority to modify funding appropriations, however the authority provided is to increase not decrease these appropriations. This authority is provided in Budget Act Control Sections and requires approval from the Joint Legislative Budget Committee. However, once a budget bill is enacted, the Governor has no authority to reduce appropriations without legislative authority. This leaves the Administration with three basic options to address budget shortfalls: (1) freeze hiring, contracting, and purchasing; (2) seek legislation to reduce spending or increase taxes; or (3) carry a deficit over to the following fiscal year.

From 1939 until 1983, the Governor of California had broad authority to alter and revise the state budget during a fiscal year. Government Code Section 13322 authorized the Department of Finance to modify appropriations if, in its opinion, it was in the interest of the state. This authority was last exercised in January 1983. In July 1983, the Legislature repealed the authority to revise the budget after enactment.

In the past 15 years, various expenditure reduction "trigger" mechanisms have been used to ensure alignment of expenditures and revenues. From 1990 to 1996, these trigger mechanisms required pro rata reductions in General Fund spending when projected revenues for the following fiscal year were one-half of one percent below a projected "workload budget". For fiscal years 1994-95 and 1995-96, "trigger" legislation provided for mid-course reductions of General Fund expenditures to ensure that the state would have sufficient cash to pay off short-term loans.

In response to the above referenced volatiltiy in economic fee costs the Administration proposes to restore both the mid-course correction authority and the automatic expenditure reduction "trigger" mechanism. The mid-course correction mechanisms proposed would allow the Director of Finance to revise, alter, or amend the budget following enactment, if required to protect the financial interest of the state. The trigger mechanism would automatically reduce appropriations (with specified exemptions) on a date certain if General Fund revenues or expenditures deviate significantly from the forecast, potentially creating a deficit.

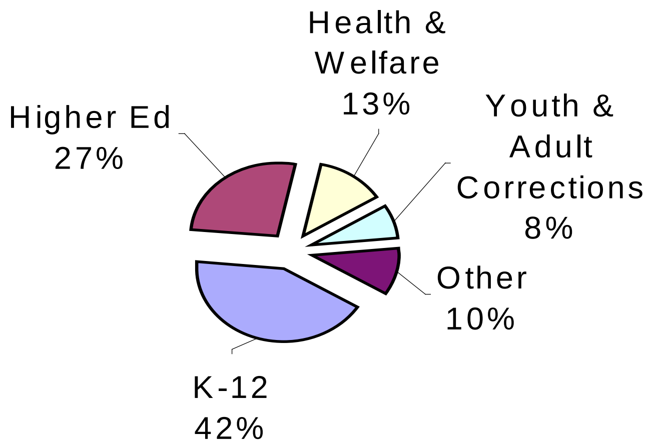
The Administration proposes to work closely with the Legislature to craft these mechanisms to ensure prudent fiscal management of state programs with appropriate legislative oversight and input.

EXPENDITURES

Governor Davis' first budget emphasizes K-12 education. In his State of the State speech, he described his first budget by saying, "My first, second and third priority is education." He proposes major initiatives to improve reading skills, enhance professional quality, and increase school accountability.

In total, the Governor's budget proposes to appropriate $60.5 billion from the General Fund in 1999-00. Of this amount, $26 billion would be allocated from the General Fund for K-12 education, about 42 percent of the budget. Higher education (the University of California, California State University and the community colleges) would receive $16.4 billion from the General Fund, about 27 percent. Health and Welfare, Corrections and General Government would split the remaining third of the General Fund. Figure 1 graphs the Governor's budget proposal to display the relative appropriations by these major program areas.

Chart 1



A "Workload" Budget Would Increase Appropriations by Nearly Four Percent: The proposed budget would increase state appropriations from $58.3 billion in the current year to $60.5 billion, for a 3.8 percent increase. Under the Governor's proposal, K-12 Education and Health and Welfare would receive the greatest increase (8.4 percent and 3.3 percent, respectively). General Government would fall from $6.3 billion to $6.1 billion (a 3 percent reduction). Table 2 compares the change in appropriations by major program area.

Table 2

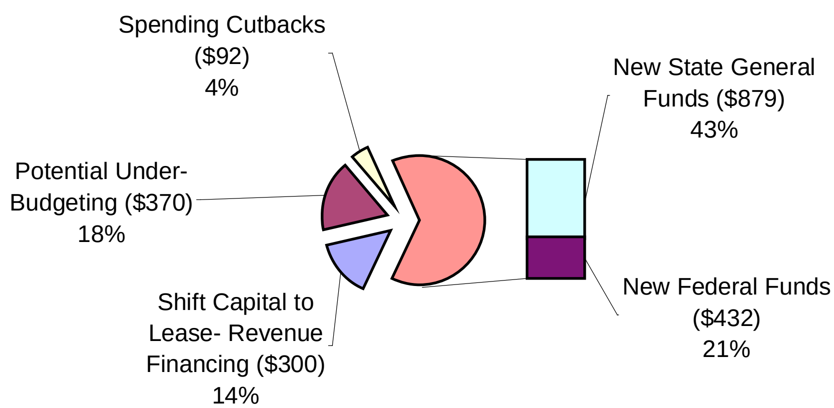
GOVERNOR'S PROPOSED BUDGET
BY MAJOR SPENDING PROGRAM AREA
1998-99 AND 1999-00
(Dollars in millions)

	1998-99	1999-00	Percent Change
K-12 Education	$23,648	$25,642	8.4
Higher Education	16,312	16,385	0.5
Health and Welfare	7,477	7,726	3.3
Youth and Adult Corrections	4,510	4,589	1.7
General Government	6,325	6,133	-3.0
Total	**$58,271**	**$60,475**	**3.8**

As noted above, the proposed budget has been characterized as a 'workload' budget. As such, it tends to continue the programs at service levels approved by the Legislature last year, after accounting for cost increases and changes in populations served. However, the Governor does not propose to fund all cost increases associated with inflation and caseload. As such, the budget is balanced in part by reducing some expenditures relative to last year's budget.

Funding a Deficit: In its initial review of the budget, the Legislative Analyst's office identified a $2.1 billion deficit. According to the LAO, the Governor closed the budget deficit by deploying the following strategies: increasing state resources, reducing spending, and changing the way capital projects are financed. Chart 2 illustrates how these strategies were used to close the deficit.

Chart 2: Closing the Deficit
Dollars in Millions



Nearly two-thirds of the deficit is financed by increasing resources. The Governor assumes $879 million will be financed with new state General Funds, and another $432 million will come from the federal government.

The Analyst's office also identifies reductions in appropriations which were used to close the deficit. It notes that $92 million of these reductions are associated with program cuts. In addition, the Governor proposes to shift the cost of capital financing from pay-as-you-go to lease-revenue financing, for a savings of about $300 million. This financing change allows the state to spread the cost of capital over several budgets, rather than financing the whole cost in 1999-00.